#23 GAO Federal Entity (Auditor / User)

GAO@100 U.S. GOVERNMENT ACCOUNTABILITY OFFICE
A Century of Non-Partisan Fact-Based Work

441 G St. N.W.
Washington, DC 20548

February 11, 2021

Monica R. Valentine, Executive Director
Federal Accounting Standards Advisory Board
441 G. Street, NW, Suite 1155
Washington, DC 20548

GAO's Response to FASAB's Joint Exposure Draft, *Omnibus Amendments to Lease-Related Topics* – and the Accounting and Auditing Policy Committee (AAPC) Federal Financial Accounting Technical Release (TR) – *Implementation Guidance for Leases*.

Dear Ms. Valentine:

Thank you for the opportunity to provide our comments on the Federal Accounting Standards Advisory Board (FASAB or "the Board") Joint Exposure Draft – *Omnibus Amendments to Lease-Related Topics* – and the Accounting and Auditing Policy Committee (AAPC) Federal Financial Accounting Technical Release (TR) – *Implementation Guidance for Leases*. Our response generally follows the questions for respondents (QFR) and specific matters for comment (SMC) detailed in the exposure draft. Our responses to the questions follow in the enclosure to this letter.

Please contact Robert Dacey, Chief Accountant at (202) 512-7439 or daceyr@gao.gov or me at (202) 512-9399 or malenichj@gao.gov if you have questions on GAO's perspectives.

Sincerely yours,

J. Lawrence Malenich

J. Lawrence Malenich
Managing Director
Financial Management and Assurance

Enclosure

QFR 1. Do you generally support the proposed Statement and TR proposals as a whole? Please provide reasons for your views.

GAO Comments

Yes. Generally we believe that the proposed amendments to Statement of Federal Financial Accounting Standard (SFFAS) 54 are appropriate, and that the proposed Technical Release (TR) for implementation of the lease standard will be helpful to the preparer and auditor community.

QFR 2. Are there specific aspects of the proposed Statement and/or TR that you disagree with? If so, please explain the reasons for your positions, the paragraph number(s), and/or topic area(s) of the proposals that are related to your positions, and any alternatives you propose and the authoritative basis for such alternatives.

GAO Comments

Please see our specific comments on the proposed Statement and TR below.

QFR 3. Are you aware of any implementation issues that are not addressed in the proposed Statement and/or TR? Do any ambiguous areas remain that could lead to challenges with implementing SFFAS 54 requirements? If so, please provide examples of the issues and any references to applicable guidance, and/or topic area(s) related to the issues, and any potential solutions you propose.

GAO Comments

Please see our specific comments on the proposed Statement and TR below.

QFR 4. Are there specific aspects of these proposals that you favor or otherwise wish to provide comments on?

GAO Comments

Please see our specific comments on the proposed Statement and TR below.

SMC 1 and paragraph 4 of the proposed TR

SMC 1. Is the proposed guidance under paragraph 4 of the proposed TR applicable to federal lease scenarios to your knowledge? Please provide feedback regarding the usefulness of the proposed guidance in the context of those scenarios and/or the extent to which you believe the proposed guidance addresses implementation issues under potential scenarios. Please describe any alternative views or suggestions for improvement.

4. A reporting entity obtains the right to use a building, which has a market rent of $500,000 per year, for a cost of $100 per year. Should the reporting entity apply the requirements in SFFAS 54 to that transaction?

Yes, the reporting entity should apply SFFAS 54 requirements to the transaction. The definition of a lease in paragraph 2 of SFFAS 54 specifies that a lease is a contract or agreement whereby one entity (lessor) conveys the right to control the use of property, plant, and equipment (PP&E) (the underlying asset) to another entity (lessee) for a period of time as specified in the contract or agreement in exchange for consideration, even though the consideration provided is less than full cost.

For inter-entity transactions (that is, intragovernmental leases), SFFAS 54 requirements continue to apply. Additionally, to the extent that the consideration provided is less than full cost incurred by the lessor, the receiving entity (lessee) should determine whether to recognize the difference in its accounting records as a financing source based on SFFAS 4, *Managerial Cost Accounting Standards and Concepts* (as amended by SFFAS 55, *Amending Inter-entity Cost Provisions)*, paragraphs 8-9 and 108-113A. This difference would be based on the full cost to the lessor (for example, depreciation) rather than the market rent.

GAO Comments

We do not believe the question in paragraph 4 of the proposed TR is necessary or appropriate for several reasons.

- It is not clear that this scenario would likely have a significant, if any, effect on lease reporting – Per SFFAS 54, leases with non-federal entities are recorded based on the specific lease terms and below market rates, if any, would not seem to affect the amounts recognized for leases. Also, we do not believe it is common for private sector entities to provide the federal government deeply discounted leases. Similarly, we are not aware of circumstances where rent on intragovernmental leases is routinely significantly less than lessor cost. For example, General Services Administration has consistently reported revenues in excess of costs for its building management operations (which includes both leased and owned properties). Consequently, imputed costs and revenues, if any, may not be significant.

- It is not clear that SFFAS 4, as amended by SFFAS 55, should be applied to leases – The response does not clearly explain the basis for recognizing imputed costs and revenues or explain how SFFAS 4, as amended, should interact with SFFAS 54. SFFAS 54, paragraph 26 states, in part, that "Any lease that meets the definition of an intragovernmental lease would be required to follow the accounting and disclosure guidance described in paragraphs 27–38." Paragraphs 27 and 28 indicate that the leases should be recognized based on the provision of the contract or agreement. We note that neither paragraph 27 nor paragraph 28, (or any other paragraph in SFFAS 54) suggest that a reporting entity, for an intragovernmental lease, may use any accounting treatment other than following the provisions of the contract or agreement. If imputed costs were to be recognized for leases, lessors would be expected to provide cost information (for both owned and leased assets) for all leases so that it could be determined whether an imputed cost should be recorded. Further, it is not clear whether, if applied, this would affect all intragovernmental lessees or only those with business-type activities. We suggest that the Board consider clarifying in the lease standard whether SFFAS 4, as amended, should be applied to leases and, if so, how it should be applied. As noted above, imputed costs, if SFFAS 4 were applicable, may not be significant, but the development of reliable lessor costs could be significant.

- The response in paragraph 4 of the proposed TR does not clearly illustrate the implementation issue or explain why this is considered to be a lease – It is not clear what point this question is seeking to illustrate and how that may be different for intragovernmental and non-intragovernmental leases. If this is intended to illustrate whether a below market or below cost rent affects the determination of whether it is a lease, it does not clearly explain that point. Also, there may be confusion between the effect of below market rent in the question and below cost rent in the answer.

SMC 2 and paragraph 13 of the proposed TR

SMC 2. Please provide feedback regarding the usefulness of the proposed guidance under paragraph 13 of the proposed TR and/or the extent to which you believe the proposed guidance addresses implementation issues related to federal oil and gas leases. Please describe any alternative views or suggestions for improvement.

13. A reporting entity (lessor) enters into a lease agreement that conveys control of the right to use a parcel of federal land to a company that engages in oil and gas exploration, development, and production. Does the agreement meet the definition of a lease under SFFAS 54?

Yes, leases of land for purposes of oil and gas exploration, development, and production are within the scope of SFFAS 54. Such agreements convey the right to obtain and control access to economic benefits from use of PP&E for a period of time in exchange for consideration, as provided for in paragraphs 2-3 of SFFAS 54. The lease liability would include all variable payments that are fixed in-substance in accordance with paragraphs 40.c and 41 of SFFAS 54. However, variable payments that are based on future performance of the lessee or usage of the underlying asset (that is, variable payments based on levels of exploration, development, and production) should not be included in the lease liability.

GAO Comments

The proposed TR expands lease accounting to include leases of land for purposes of oil and gas exploration, development, and production. In developing SFFAS 54, the Board in August 2017, decided to narrow the scope of SFFAS 54 from the "right to use a nonfinancial asset" to the "right to control the use of another's property, plant, and equipment" and concurrently removed the scope limitation that indicated that "This Statement does not apply to leases of federal natural resources as defined in Technical Bulletin (TB) 2011-1, *Accounting for Federal Natural Resources Other than Oil* [sic] and leases of federal oil and gas resources as defined in SFFAS 38, *Accounting for Federal Oil and Gas Resources*." It appears that after adopting the narrower lease definition, many of the scope exclusions, including the exclusion for natural resources, were no longer needed, and thus were eliminated. The proposed TR states that "leases of land for purposes of oil and gas exploration, development, and production are within the scope of SFFAS 54."

It is not clear that the Board intended to include natural resource accounting within the scope of SFFAS 54. Per SFFAS 54, a lease is defined as a contract or agreement whereby one entity (lessor) conveys the right to control the use of property, plant, and equipment (PP&E) (the underlying asset) to another entity (lessee) for a period of time as specified in the contract or agreement in exchange for consideration. Lease in this definition is for "the use of property," not for exploration or exploitation of the property. "Use" of property can be seen as distinctly different from "exploration" or "exploitation" of property. Use allows the lessee to use the property, however the lessee returns the property to the lessor without taking away a portion of the leased property. Exploration is generally a precursor to exploitation. Exploitation, for example in this case oil and gas, is the removal and sale of the natural resources which, upon the lessee returning the property to the lessor, the property has a diminished natural resource content.

In addition, par. 2 of SFFAS 54 states, in part, that a lease "conveys the right to control the use of property, plant, and equipment (PP&E)" and, via footnote 2, makes explicit reference to SFFAS 6 for PP&E. The definition in SFFAS 6 of PP&E does not include natural resources. Natural resources are partially addressed in other standards. SFFAS 7 includes discussion of accounting treatment for royalties. SFFAS 38 requires certain reporting in required supplementary information relating to royalties from the production of federal oil and gas proved reserves. TB 2011-1, expands such reporting to federal natural resources other than oil and gas. SFFAS 54 makes no mention of incorporating natural resources exploration, development and exploitation, or suggests a modification to other FASAB guidance specifically applicable to natural resources.

Agreements related to oil and gas exploration, development, and production are generally complex and have multiple types of cash flows. If the Board believes that certain portions of oil and gas exploration, development, and production agreements constitute leases under SFFAS 54, the Board should clarify the lease standard, including the nature of the activity imbedded in oil and gas exploration, development, and production agreements that would constitute leases under SFFAS 54.

Paragraphs 89-92 of SFFAS 54, SMC 3 and paragraph 95 of the proposed TR

> **SMC 3.** Is the proposed guidance under paragraph 95 of the proposed TR potentially applicable to intragovernmental transactions that are similar to a sale-leaseback to your knowledge? Please provide feedback regarding the usefulness of the proposed guidance in the context of those scenarios and/or the extent to which you believe the proposed guidance addresses implementation issues under potential scenarios. Please describe any alternative views or suggestions for improvement.
>
> **95. Do the disclosures for sale-leaseback transactions apply to short-term and intragovernmental leases?**
>
> The requirements of paragraphs 89-92 of SFFAS 54 apply to short-term leases that are part of sale-leaseback transactions, provided that, the transaction qualifies as a sale under SFFAS 7, paragraph 295.
>
> For intragovernmental leases, paragraph 89 of SFFAS 54 provides that a similar intragovernmental transaction would not qualify as a sale under SFFAS 7, paragraph 295. Paragraph 295 of SFFAS 7 only applies to sales transactions with the public. As such, intragovernmental sale-leaseback transactions do not include transactions that would qualify as a sale and should be accounted for as a borrowing by both the seller-lessee and the buyer-lessor, in accordance with paragraph 89 of SFFAS 54.

GAO Comments

It is not clear why there cannot be a sale or sale-leaseback for intragovernmental transactions. While paragraph 295 of SFFAS 7 discusses sales transactions with the public, other parts of SFFAS 7 discuss intragovernmental exchange transactions in similar terms (e.g., Revenue from exchange transactions should be recognized when goods or services are provided to the public or another Government entity at a price).

Further, paragraphs 89-92 may appear to be inconsistent with par. 26 that states, in part – “Any lease that meets the definition of an intragovernmental lease would be required to follow the accounting and disclosure guidance described in paragraphs 27–38.” Also, paragraphs 89-92 of SFFAS 54, in the context of intragovernmental leases, and paragraph 95 of the proposed TR appear to introduce a level of complexity for intragovernmental leases that the Board, in SFFAS 54’s basis for conclusions, may have wished to avoid.

We suggest that the Board clarify in the standard the applicability of paragraphs 89-92 of SFFAS 54, in the context of intragovernmental transactions, and the consistency of such paragraphs with par. 26 of SFFAS 54. If the Board determines to make any modifications to SFFAS 54, conforming changes should be made to the proposed TR as appropriate.

Paragraph 93 of SFFAS 54, SMC 4, and paragraph 98 of the proposed TR

> **SFFAS 54, par. 93**. In a lease-leaseback transaction, an asset is leased by one party (first party) to another party and then leased back to the first party. The leaseback may involve an additional asset **(such as leasing a building that has been constructed by a developer on land owned by and leased back to a federal entity)** or only a portion of the original asset (such as leasing back only one floor of a building to the owner). A lease-leaseback transaction should be accounted for as a net transaction. Both parties to a lease-leaseback transaction should disclose the amounts of the lease and the leaseback separately. [**emphasis added**]
>
> **SMC 4.** Is the proposed guidance under paragraph 98 of the proposed TR applicable to existing and/or potential intragovernmental lease-leaseback transactions to your knowledge? Please provide feedback regarding the usefulness of the proposed guidance in the context of those scenarios and/or the extent to which you believe the proposed guidance addresses implementation issues under potential scenarios. Please describe any alternative views or suggestions for improvement.
>
> **98. A reporting entity leases land to a contractor on which the contractor will build a new building and lease both the land and the building back to the reporting entity. The reporting entity makes advance lease payments to the contractor during construction. How should the reporting entity report the lease during the construction period?**
>
> Prior to the new building being made available to the reporting entity, the lease of the land to the contractor should be reported as a standalone lease. Any lease payments made to the contractor prior to the new building being made available should be reported as an advance. Once the new building is made available to the reporting entity, the lease and the prepayment should be accounted for as a lease-leaseback transaction (see also: TR par. 18 and 54).

GAO Comments

Concerning the question in SMC 4, it is unclear whether the guidance in par. 98 of the proposed TR is applicable to intragovernmental lease-leaseback transactions because, in our view, the applicability of SFFAS 54, par. 93 to intragovernmental transactions appears unclear as well. One interpretation may be that the accounting and reporting requirements for intragovernmental leases are limited to SFFAS 54, par. 27-38. Another interpretation may be that the requirements in SFFAS 54, par. 70-93 apply to intragovernmental leases to the extent that such requirements are not inconsistent with par. 27-38. Also, it is not clear why, in the example provided, this is not an in-substance financing of the building and what happens to the title of the building at the end of the lease.

We suggest clarifying the applicability of paragraph par. 93 of SFFAS 54 to an intragovernmental lease-leaseback transaction and why, in the example provided, this is not an in-substance financing of the building. If the Board determines to make any modifications to par. 93 of SFFAS 54, conforming changes, as appropriate, should be made to the proposed TR as well.

Par. 6 of the Exposure Draft Statement - par. 23 of SFFAS 54

GAO Comments

The wording in the middle of the paragraph – "for rent due if payments are made subsequent to that reporting period" perhaps should be changed to - "due and unpaid at the end of the reporting period." The liability recognition is not a function of the subsequent payment made, rather a function of an obligation that existed at the end of the reporting period.

Par. 25 of the Exposure Draft Statement - par. 18 of SFFAS 6

GAO Comments

We question whether leasehold improvements should be stricken from par. 18 of SFFAS 6. As leasehold improvements are tangible assets that generally are consistent with the definition of property, plant and equipment in paragraph 17 of SFFAS 6, it would appear appropriate in most circumstances to include leasehold improvements as a subcomponent of property, plant and equipment. However, if the Board determines that leasehold improvements should not be part of property, plant and equipment, we suggest that the Board (i) make such exclusion explicit in SFFAS 6 paragraph 19, and (ii) provide guidance as to how leasehold improvements should be reported. In a related matter, it is not clear how leasehold and lessor improvements should be treated for non-intragovernmental leases. While paragraphs 34 and 35 of SFFAS 54 provide guidance for leasehold and lessor improvements as part of intragovernmental leases, they are not clearly discussed in relation to non-intragovernmental leases.